LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"There is nothing like higher prices to attract more buyers. In department stores you mark merchandise down to move it. On Wall Street you mark it up."
- Michael Metz

The question of where the market is has to do with what you look at. The movements of the major averages are deeply influenced by well-known companies that have large capitalizations. For example, the 50 largest companies in the Standard & Poor's 500 Stock Index accounted for 54.9% of its total value as of December 31, 1998.

Performance wise, the 50 largest stocks – representing just 10% of the total number of companies in the index – accounted for over 50% of the index's appreciation in each of the last four years. This was especially apparent in 1998, when the 50 largest companies accounted for 68.7% of the S&P 500's return according to Paine Webber. Even more astounding, as reported in *The Kiplinger Washington Letter* of March 19, 1999, is that just 15 stocks accounted for about half of the S&P 500's return last year. This phenomenon continues in 1999. A Salomon Smith Barney study indicated that the performance of just 21 big stocks explained all of the S&P 500's advance during the first quarter. The other 479 cancelled each other out.

The growing gap between a few leading shares and the rest of the market has created a very difficult environment for professional investors. While the S&P 500 was up 28.58% last year, the average U. S. common stock mutual fund advanced 14.31% according to Morningstar, Inc. For the first quarter of 1999, Lipper Inc. has calculated that the average U. S. common stock fund increased 0.93% while the S&P 500 advanced 4.94%.

A number of reasons for this situation have been given. One argument is that larger companies recently have had better fundamentals and earnings growth. After peaking in 1994, the rate of profit growth has declined erratically. During this period, when growth in earnings became ever more selective, investors increasingly shifted more of their funds into the companies with more predictable earnings which were perceived as better able to cope. As noted in the March 20, 1999, issue of *The Economist*, this strategy had validity. "Last year, most of the 50 biggest S&P 500 shares delivered higher profits, whereas the earnings of nearly two-thirds of the remaining 450 fell." The question at this point is whether the strategy has gone too far. The same article states, "The average p/e of the 100 biggest S&P 500 companies – around 32 times forecast 1999 profits – is well above the 19 times for the smallest 100."

Another common explanation for the divergence is that fund managers wary of how earnings problems can destroy a stock, yet perceiving a need to stay fully invested, are disproportionately favoring the perceived security of a few large and highly-liquid issues. This type of situation where performance is chasing performance becomes self-reinforcing as investors, including mutual funds, are channeling their funds to a shrinking list of recent winners. The primary source of funds for these investments is underperforming, smaller, and value-oriented stocks and mutual funds. This phenomenon explains why during 1998, 38% of the funds had outflows, and about half of all domestic stock funds had net outflows of money during the first two months of 1999, according to Financial Research Corp.

The narrowness of this market has led to a feast or famine situation for portfolios. The variance in performance is as wide as it has ever been. For those who have underperformed, there is pressure to abandon diversification and target their portfolios toward an ever-narrowing slice of the equity market. We believe this course of action is imprudent and clearly risky. Day traders may disagree, but our years of experience have taught us to respect diversification's ability to temper volatility.

Many bull markets in the past have ended with a final, very selective rally that was fueled by an ever-narrowing list of blue-chip issues while the broad list of stocks languished or declined. When the correction finally arrived, it was the leaders that suffered the greatest declines and the better performance came from the more diversified portfolios.

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